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JAMES R. BROWNING, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 363

O LIQUIDATING CORPORATION,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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TO THE HONORABLE THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES.

Your Petitioner, O Liquidating Corporation, respectfully prays that a writ of certiorari be issued out of and under the Seal of this Court to review the decision of the United States Court of Appeals for the Third Circuit, which, by a divided Court, reversed a judgment of the United States Tax Court, and in support thereof your petitioner respectfully says:

Opinions Below.

The Memorandum Findings of Fact and Opinion of the Tax Court upon which the judgment was entered in the Tax Court are reported at 19 CCH Tax Court Mem. 154 (1960). A copy of the opinion of the Tax Court appears in the Commissioner's Appendix below (6a-20a).[1]

The opinions, majority and dissenting, of the Court of Appeals, which reversed the judgment of the Tax Court were filed on June 14, 1961, but have not yet been reported. Copies of these opinions are annexed to this petition as Appendix 1.

Jurisdiction.

The grounds on which the jurisdiction of this Court is invoked are:

(i) The date of the Judgment sought to be reviewed and the time of the entry of said judgment is June 14th, 1961.

(ii) No motion for a rehearing was made. The time to file a petition for a writ of certiorari has not been extended.

(iii) The statutory provision which the petitioner believes confers jurisdiction on the Supreme Court to review the said judgment by writ of certiorari is Title 28 U. S. C. A. §1254 (1); C. 646, 62 Stat. 928.

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[1] References followed by an "a" are to pages of the Commissioner's Appendix in the Court of Appeals.

References followed by a "b" are to pages of the taxpayer's Appendix in the Court of Appeals.

Question Presented.

The following question is presented for review:

Did the Commissioner have discretion to refuse to permit a taxpayer in one year to correct an admitted error in his treatment of similar items of income in prior years?

Stated another way:

Did the Commissioner have the power to require a taxpayer to report, erroneously, unaccrued income in 1953, for the reason that the taxpayer had previously made similar errors?

Statutes and Regulations Involved.

The case involves §41 of the Internal Revenue Code of 1939 (26 U. S. C. 1952 ed., sec. 41); section 42 (a) of the Internal Revenue Code of 1939 as amended by section 114 of the Revenue Act of 1941, ch. 412, 55 Stat. 607; (26 U. S. C. 1952 ed., sec. 42 (a)); and Treasury Regulation 118, §§39.41-1, 39.41-2, 39.41-3, and 39.41-4 promulgated under the Internal Revenue Code of 1939. Complete copies of these sections and regulations are annexed to this petition as Appendix 2.

Statement of the Case.

The taxpayer has at all times kept its books and reported its income on a calendar year and accrual basis (1b).

In the year 1918, taxpayer established, and has since broadened and continuously maintained, a group insurance plan for its employees (2b). The premiums on the policies carried pursuant to that plan were paid by taxpayer in

monthly installments (3b). All of the policies here involved were written by the Equitable Life Assurance Society of the United States, a mutual company, hereinafter referred to as Equitable Life, and each had a policy year coterminous with the calendar year (3b). With one exception, each of the policies contained the following provision for the payment of annual dividends (8a):

> The surplus, if any to be distributed upon this policy as a dividend shall be ascertained and distributed by the Society annually as of each policy anniversary provided this policy shall have been continued in force by the payment of all premiums hereunder to such policy anniversary; otherwise the Society shall not distribute any surplus upon this policy. Any surplus apportioned to this policy in accordance with this provision shall be paid in cash to the Employer, or, upon written notice to the Society by the Employer, may be applied by the Employer to the payment of any premium hereon.

Pursuant to that provision, at its regular meeting in February, the board of directors of Equitable Life determined the formula upon the basis of which the dividend, if any, would be distributed (14b).

These dividends were actually received by the taxpayer in late March or April of each year (14b).

In years past, prior to 1953, the taxpayer had fallen into the error of reporting these dividends in the year preceding the year in which such dividends were declared, had accrued and were received (3b). The Commissioner does not contest the finding that in each year "the dividends accrued in the years of receipt" (Page 6 of opinion below Appendix 1).

In most instances this presented no problem. Usually the exact amount of the dividends was known by April and

before the taxpayer's books had been closed for the previous year (14b).

In some years, however, the amount of the dividend was not then known (14b) and in those years the taxpayer had made a rough estimate and accrued such estimate into the prior year (7b, 8b). These estimates, of course, were never "on the nose" and the taxpayer accrued the difference either as additional income, if over, or as additional expense, if under, in the year in which the exact amount became known and the dividend was received (7b, 8b). This method of estimating and accruing such estimate first came to the Commissioner's attention with the taxpayer's return for 1950 (7b). Upon an examination of the 1950 return the Commissioner made an adjustment increasing the taxpayer's income by the difference between the actual dividend and the estimated dividend. This determination was made by the Commissioner on March 12, 1953 (7b).

The taxpayer had no difficulty in this respect when closing its books in 1953 for 1952, since in 1953 the exact amount of the dividend was known before the auditor's letter (14b). However, in 1954, for the first time, the taxpayer was faced, on the one hand, with the Commissioner's determination that an estimate was not permissible and, on the other hand, with the lack of knowledge of the exact amount of the dividend (14b). In this dilemma and upon careful study of the problem for the first time, the taxpayer did not report an estimate for 1953.

The entire dividend appeared in the taxpayer's return for 1954 the year in which the dividend accrued, became known in amount and was received. The item has not escaped taxation (11b). It has borne its proper share of taxes as applicable in 1954. Moreover the dividends received in 1953 and which had accrued in that year had been reported erroneously in 1952 and subjected to tax

rates identical with the rates applicable to 1953 income (8b).

The taxpayer did not request permission of the Commissioner to correct the error in reporting these dividends. The filing of the return on June 14, 1954 (14b) cannot be regarded as a request by the taxpayer. Under the regulations (see Appendix 2) a request to change must be filed "within 90 days after the beginning of the taxable year covered by the return."

In 1956, the Commissioner examined the taxpayer's return for the year 1953 and made a determination that the dividend of $114,117.44 received by taxpayer in 1954 should have been accrued and reported in 1953. On the basis of such determination a difficiency was assessed for 1953 in the sum of $78,851.43.

On a petition for a redetermination The Tax Court found that since the dividends had not accrued until the year of receipt the practice of reporting in the year prior to payment was in error; that the change in the treatment of the item by the taxpayer in its return for 1953 did not constitute a "change in its method of accounting"; and that the Commissioner could not require that an error be perpetuated.

Accordingly the Tax Court held that the dividends were properly reported in 1954, the later year.

By the same process of reasoning the Tax Court held that the dividend, which had been received by the taxpayer in 1953 but reported in 1952, should be included in 1953. Mindful of the fact, however, that this dividend had already been taxed as 1952 income, the Tax Court pointed out that the taxpayer would have relief from double inclusion by virtue of the provisions of section 1311 *et seq.* of the Internal Revenue Code of 1954.

On appeal by the Commissioner the Court of Appeals for the Third Circuit, Forman C. J. dissenting, reversed the judgment of the Tax Court, and reinstated the determination made by the Commissioner. The majority of the Court of Appeals held that the taxpayer had changed its method of accounting; that the Commissioner had broad discretion to refuse to grant his consent to the correction of this error and that in this case such discretion had not been abused.

Jurisdiction of the Court of First Instance.

The United States Tax Court was the Court of first instance. The Tax Court had jurisdiction to redetermine income and excess profit tax assessments made by the Commissioner of Internal Revenue (section 6214 of the Internal Revenue Code of 1954; 26 U. S. C. A. 6214). The taxpayer's original petitioner to the Tax Court sought such a redetermination.

Reasons for Granting the Writ.

1. The Court below has rendered a decision in conflict with a decision of the Court of Appeals for the Tenth Circuit.

2. The Court below has decided an important federal question in a way in conflict with applicable decisions of this Court.

3. The Court below has reversed a determination of the Tax Court which was not "clearly erroneous."

I.

This decision of the Court of Appeals for the Third Circuit is in conflict with the decision of the Court of Appeals for the Tenth Circuit on the same matter.

In the case at bar the Court of Appeals for the Third Circuit has held that a taxpayer, when acting on his own initiative, may not correct an error in his prior method of reporting an item of recurring income, without the consent of the Commissioner.

This decision is in conflict with *Beacon Publishing Co.* v. *Commissioner of Internal Revenue,* 218 F. 2d. 697 decided by the Court of Appeals for the Tenth Circuit in 1955. In *Beacon Publishing Co.,* the taxpayer kept its books and filed its returns on the accrual basis. Prior to 1943 Beacon reported as income all sums received as prepaid subscriptions for subsequent years. This was error, as the item, representing prepaid subscriptions, did not accrue until the subsequent years. In 1943 the taxpayer, without any action on the part of the Commissioner, corrected this error by setting up as a liability the sums received in 1943 from prepaid subscriptions. The Commissioner urged, as does the Commissioner in the case at bar, that the taxpayer could not "change its system of accounting without the consent of the Commissioner". It was held that the taxpayer had not changed its accounting system; that it had done no more than apply the method in use so as to clearly reflect income. Pickett, C. J. said at pages 701, 702:

> "The Commissioner urges that since the taxpayer had for years prior to 1943 and 1944 carried these accounts on its books as cash items, it cannot change its system of accounting without the consent of the Commissioner. Treasury Regulations 111, Sec.

29.41-2. The Commissioner is vested with wide discretion in determining whether a change in a taxpayer's method of accounting shall be allowed. Brown *v.* Helvering, 291 U. S. 193, 54 S. Ct. 356, 78 L. Ed. 725; Aluminum Castings Co. *v.* Routzahn, *supra;* United States *v.* Anderson, *supra;* United States *v.* American Can Co., 280 U. S. 412, 50 S. Ct. 177, 74 L. Ed. 518; Niles Bement Pond Co. *v.* United States, *supra.* The taxpayer, however, did not seek to change its accounting system. It did no more than apply the method adopted and in use to clearly reflect its income. This the taxpayer had the right to do and the Commissioner had the right to require it. United States *v.* American Can Co., *supra.* A discretion of the Commissioner does not empower him to add to the taxpayer's gross income for a given year, an item which rightfully belongs in another year. Commissioner *v.* Frame, 8 Mnookin's Estate, 8 Cir., 184 F. 2d 89.

We have no doubt that the taxpayer could not change its method of keeping books without the consent of the Commissioner, even as to items, if the change resulted in an avoidance of the payment of taxes due, nor do we have any doubt but that a taxpayer may, without the consent of the Commissioner, apply the method of accounting which he has adopted, though not theretofore applied to a particular item, when that change will correct errors and clearly reflect his income. We think the change in this case falls within the latter category."

In *Beacon* as well as in the case at bar the correction postponed the payment of taxes but in neither case did the correction avoid the payment of taxes. It does not follow, as stated by the Court of Appeals (Appendix No. 1, p. 5) that the decision of the Tax Court allowed one year's dividend to be "deleted." The 1954 and subsequent dividends were merely deferred until the proper year.

For its decision the Tenth Circuit relied in part upon *Commissioner* v. *Frame* (C. A. 8), 195 F. 2d 166 and *Commissioner* v. *Mnookins Estate* (C. A. 8), 184 F. 2d 89. In each of those cases it was held that the discretion given the Commissioner by section 41 of the 1939 Code did not empower him to add to the taxpayer's gross income, for a given year, an item which rightfully belonged in another year.

The Third Circuit, in the case at bar, attempted to distinguish *Commissioner* v. *Frame*, and *Commissioner* v. *Mnookins Estate* upon the ground that in each of those cases the Commissioner had first raised the issue by requiring the taxpayer to change from one accounting method to another. That fact did exist in each of those cases. But this difference cannot logically justify a distinction. Section 41 gave the Commissioner power to require the taxpayer to report income in such a way as "in the opinion of the Commissioner does clearly reflect the income." The only limitation placed upon this power is that the Commissioner must be of the opinion that his method will clearly reflect income.

Accordingly it should not be material whether the taxpayer or the Commissioner initiated the change. In either case it was intended that the Commissioner should have the power to require a method which in his opinion does clearly reflect income. He and those in his department as well as the Judges of the Tax Court are specialists in such matters and they must be allowed to apply the "varying interpretations and divergent methods" to which the underlying principles of accounting are subject. (*Advertisers Exchange, Inc.* v. *Commissioner* (C. A. 2), 240 F. 2d 958, affirming 25 T. C. 1086).

In the instant case, however, the Commissioner does not claim that the item accrued in 1953. In effect he concedes that the inclusion of the 1954 dividend in 1953 will not clearly reflect 1953 income, and the Tax Court has so found. When he came to that conclusion his power under section 41 ended.

II.

The ruling of the Tax Court that the taxpayer did not change its method of accounting in 1953, should not have been set aside by the Court of Appeals.

The Judges of the Tax Court are specialists in a highly complex subject. Probably the most complex phase of tax administration relates to accounting methods. In this case the Tax Court gave careful consideration to this problem and held (19a)

> "* * * that the petitioner did not change its method of accounting in 1953"

The Court of Appeals ignored this determination and held that the taxpayer had not only changed its method of accounting but also that the Commissioner was justified in challenging the taxpayer's right to do so. By this the Court of Appeals has failed to give the findings of the Tax Court that degree of finality to which they are entitled. As Mr. Justice Brennan said in *Commissioner* v. *Duberstein*, 363 U. S. 278 at page 291:

> "Where the trial has been by a judge without a jury, the judge's findings must stand unless 'clearly erroneous'. Fed. Rules Civ. Proc. 52 (a)"

Although the rule established by this Court in *Dobson* v. *Commissioner*, 320 U. S. 489 was limited by an act of the Congress (Section 1141 (a) of the 1948 amendment to the 1939 Code (Sec. 36 of the Judicial Code Act, 62 Stat. 991), now Section 7482 of the 1954 Code), nevertheless, Mr. Justice Jackson's opinion in *Dobson* stated truisms which are applicable here (p. 498):

> "It (The Tax Court) deals with a subject that is highly specialized and so complex as to be the despair of judges. It is relatively better staffed for its task than the judiciary. Its members not infrequently bring to their task long legislative or administrative experience in their subject.* * * Considerations of uniform and expeditious tax administrations require that they (decisions of the Tax Court) be given all credit to which they are entitled under the law" (words in parenthesis supplied).

III.

The Commissioner does not have discretion to disregard what he knows to be the actual transaction and to readjust income on a basis which does not conform to facts.

The Commissioner does not contest the fact that these dividends accrued in 1954 and were received by the taxpayer in 1954. The Commissioner cannot, and does not, express the opinion that the inclusion of the item in 1953 will clearly reflect income for 1953. It follows, that the Commissioner does not possess any discretion to require the inclusion of these dividends in 1953.

In fact, there is no possible basis for reporting these dividends in 1953. No method of accounting, either cash,

accrual or hybrid would permit it. If the dividends had been included in 1953 the return would not have clearly reflected the taxpayer's income. If the taxpayer had failed to report the dividends in 1954 its return would not have clearly reflected income for that year.

The taxpayer, as policyholder, had no right to expect a dividend until one had been declared by the Board of Directors of Equitable Life. The policyholder could not force the payment of a dividend either by action at law (*Greeff* v. *Equitable Life Assurance Society*, 160 N. Y. 19), or by suit in equity (*Equitable Life Assurance Society* v. *Brown*, 213 U. S. 25). The year within which the surplus was earned has no relevancy. The sole question is when was the dividend declared. (*Estate of Putnam* v. *Commissioner*, 324 U. S. 393). The dividend was declared on February 18, 1954 (14b). The formula, upon the basis of which the dividend was computed and later paid, was made up each year just before the Board meeting. It differed from year to year and was based, in important part, upon a forecast of economic events to come. Income tax liability must be determined on an annual basis and items reportable in one year may not be anticipated or postponed because in some remote manner they may be related to other years. (*Rabkin & Johnson, Federal Income Gift and Estate Taxation*, Vol. 1 Sec. 1.16(1); *Burnet* v. *Sanford & Brooks Company*, 282 U. S. 359 and *George Bradshaw*, 14 T. C. 162, Acquiescence 1950-1 CB 1).

The Court of Appeals made reference to Rev. Ruling 59-285, 1959-2 Cum. Bull. 458 which stated:

> "Prior consent must be secured from the Commissioner whether or not the taxpayer regards the method from which he desires to change to be proper."

In other words it is not the opinion of the taxpayer that counts. His feelings in the matter are quite immaterial, as they should be. The *prima facie* guide in the matter is the opinion of the Commissioner. If his opinion is obviously wrong the Court may find that he had abused his discretion. But, here, it is not necessary to consider whether or not there had been an abuse. The Commissioner concedes that the item did not accrue in 1953. There is no room for a difference of opinion.

The "broad discretion" in the Commissioner which was relied upon by the Court of Appeals relates to the matter of determining the accounting method which "in the opinion of the Commissioner does clearly reflect income." (Section 41). No discretion is given to refuse to acquiesce in a correction when the Commissioner agrees that the correction is necessary to clearly reflect income. The administrative provisions of the Code and Regulations may not be allowed to affect "taxable income" as defined in the substantive provisions.

The Court of Appeals cited two decisions of this Court to support its conclusion that such discretion had been conferred (*Brown* v. *Helvering*, 291 U. S. 193 and *Commissioner* v. *Hansen*, 360 U. S. 446). However, neither of these cases support the conclusion. In *Brown* v. *Helvering* Mr. Justice Brandeis carefully said at page 203:

> "Moreover, the method employed by the taxpayer is never conclusive. *If in the opinion of the Commissioner it does not clearly reflect the income, 'the computation shall be made upon such basis and in such manner,' as will, in his opinion, do so.* United States *v.* Anderson, 269 U. S. 422, 439; Lucas *v.* American Code Co., 280 U. S. 445, 449; Lucas *v.* Ox Fibre Brush Co., 281 U. S. 115, 120; compare Williamsport Wire Rope Co. *v.* United States, 277

> U. S. 551; Lucas *v.* Structural Steel Co., 281 U. S. 264" (emphasis supplied).

And in *Commissioner* v. *Hansen,* Mr. Justice Whittaker said at page 467:

> "The Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income, Lucas *v.* American Code Co., 280 U. S. 445, 449 Automobile Club of Michigan *v.* Commissioner, 353 U. S. 180, 189-190, and under §41 of the Internal Revenue Code of 1939, 26 U. S. C. (1952 ed.) §41, the Commissioner, believing that the accounting method employed by a taxpayer 'does not clearly reflect the income,' *may require that 'computation shall be made in accordance with such method as in* [*his*] *opinion . . . does clearly reflect the income'* " (emphasis supplied).

It follows that the discretion of the Commissioner does not empower him to insist upon a system which he knows and admits will not clearly reflect income.

Thus in *Lucas* v. *Commissioner,* 281 U. S. 115, Mr. Chief Justice Hughes said at page 120, speaking with reference to the then applicable code section similar to Section 41·

> "This Section relates to the method of accounting; the Commissioner may make the computation on a basis that does clearly reflect the income, if the method employed by the taxpayer does not. But this section does not justify the Commissioner in allocating to previous years a reasonable allowance as compensation for services actually rendered, when the compensation was properly paid during the taxable year and the obligation to pay was incurred during that year and not previously. In the present instance, the expense could not be attributed to earlier years, for it was neither paid nor incurred in those years. There was no earlier accrual of liability. It was deductible in the year 1920 or

> not at all. Being deductible as a reasonable payment, there was no authority vested in the Commissioner to disregard the actual transaction and to readjust the income on another basis which did not respond to the facts."

To the same effect see Mr. Justice Frankfurter in *Ross* v. *Commissioner* (C.A.1), 169 F. 2d 483, 493, 494.

The Commissioner claims however that adherence to the erroneous method of reporting is necessary in order to prevent an inequitable result to the Government.

IV.

A supposedly more equitable result, even if that would follow, does not justify the perpetuation of an error. Moreover it is not possible to determine where equities rest.

Taxes are based upon statutes and regulations made in pursuance thereof. If an assessment is not authorized by such statutes and regulations it must be vacated. The Commissioner has no right to make an assessment based on a claimed equity but which is not also based upon the law and regulations.

To quote from Mr. Justice Roberts in *Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281 at pages 285, 286 and 287:

> "But we think it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly

more equitable result to the Government or to the taxpayer.

* * * * * *

This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount."

But even if equities should be allowed to play a part in determining the validity and propriety of an assessment, it is not possible in this case to determine where the equity rested as between the petitioner and the respondent. Certainly for years the Government received the tax on the comparable item 12 months in advance of the date upon which the tax should have been paid. Certainly when the excess profits tax of the Second World War expired in 1946 (Internal Revenue Act of 1945, Sec. 122) the taxpayer paid an excess profits tax to which the comparable item, if properly handled, should not have been subject. The same result followed whenever the tax rates were reduced. Under similar circumstances the Courts have repeatedly refused to attempt to make an adjustment on the basis of supposed equities whether importuned to do so by the taxpayer or by the Commissioner.

To quote from L. Hand, C. J. in *Bennet* v. *Helvering* (C. C. A. 2), 137 F. 2d 537 at p. 538:

"The basic difficulty with this is that, although adopted in the name of equity, it does not do equity unless supplemented by what in the end comes to a reassessment of the first tax. It by no means follows that to cancel a deduction in a later year will

> restore the situation to what it would have been, if the tax had been assessed correctly in the first year and the deduction allowed in the second; on the contrary, it seldom, if ever, will do so. It is only in case one supplements the doctrine by limiting it to those cases in which the taxpayer gained by the omission in the first year as much as, or more than, what he will lose by cancelling the deduction in the second, that it will work out equitably, and then only on the assumption that it is inequitable in the circumstances to allow the defense of the statute of limitations. The courts which have adopted this theory, have not shown any disposition to engraft such a condition upon it; and if they had, any logical force it might have had would have disappeared, for it would emerge for what it is, if it is to be an equitable doctrine at all: i.e. an excuse for reopening the earlier assessment in the face of the statute."

And McLaughlin, C. J. in *First National Bank of Philadelphia* v. *Commissioner* (C. A. 3) 205 F. 2d 82 said at p. 84:

> "In the first place, because of the many variables too obvious to warrant discussion, allowing a double deduction for the 1941 Pennsylvania tax would not be the equivalent of allowing a deduction for the 1920 tax. Second, the statute of limitations has long ago barred adjustments to petitioner's 1921 tax return. Moreover, an adjustment of petitioner's 1921 return would necessarily require recomputations of all its returns from that year through 1942. If the statute of limitations has any purpose it is to prevent such practices. *Rothensies* v. *Electric Storage Battery Co.*, 329 U. S. 296, 67 S. Ct. 271, 91 L. Ed. 296."

In *Bennet* v. *Helvering, supra,* the rule was invoked against the Commissioner's contention and in *First*

National Bank of Philadelphia v. *Commissioner, supra,* the rule was invoked against the taxpayer's contention.

Moreover, statutes of limitations themselves fit into the equity scheme, as Mr. Justice Jackson pointed out in *Rothensies* v. *Electric Storage Battery Co.*, 329 U. S. 296, pp. 301, 302:

> "We have had recent occasion to point out the reason and the character of such limitation statutes. 'Statutes of limitation, like the equitable doctrine of laches, in their conclusive effects are designed to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them.' *Order of Railroad Telegraphers* v. *Railway Express Agency,* 321 U. S. 342, 348-9. 'They are by definition arbitrary, and their operation does not discriminate between the just and the unjust claim, or the voidable avoidable and unavoidable delay. They have come into the law not through the judicial process but through legislation.' *Chase Securities Corp.* v. *Donaldson,* 325 U. S. 304, 314.
>
> "As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out. They tempt the equity-minded judge to seek for ways of relief in individual cases.
>
> "But if we should approve a doctrine of recoupment of the breadth here applied we would seriously undermine the statute of limitations in tax matters. In many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed

by statute, at least as closely as does the item involved here. *Cf. Hall* v. *United States,* 43 F. Supp. 130. The same is true of items which form the basis of refund claims. Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup."

V.

Consistency with prior years does not justify a return which does not clearly reflect income.

The Commissioner seems to argue that the taxpayer had made an election in prior years and must be held to such an election. This might follow if the taxpayer in fact had an election to make. Since, however, the dividends always accrue in the year of their receipt, there was never a right to elect. In other words the taxpayer in prior years had erroneously accrued these dividends. The Commissioner's acquiescence in such error, even if under the circumstances he can be said to have done so, did not require the taxpayer to perpetuate this error. The Tax Court squarely rejected this contention (19a):

> "There is no basis for the proposition that because respondent has acquiesed in the erroneous treatment of the dividends in past years, such error should be perpetuated. *Wiener Machinery Co.,* 16 T. C. 48; *Mt. Vernon Trust Co.* v. *Commissioner,* 75 F. 2d 938, certiorari denied 296 U. S. 587; *Commissioner* v. *Rowan Drilling Co.,* 130 F. 2d 62. It is not yet the law that wrongs, no matter how numerous, will make right."

The ruling of the Tax Court is supported on principle as well as by authority. No estoppel can arise either against

the Commissioner for acquiescence in an error or against the taxpayer for making one.

In *Ross* v. *Commissioner* (C. A. 1), 169 F. 2d 483 a taxpayer had changed his treatment of items from cash to constructive receipt without the consent of the Commissioner so as to correct an error. The Commissioner argued that even though the old method was error, "consistent dealing with the Government" justified an assessment based on the taxpayer's old method. However, it was held that since the old method was error, the taxpayer had no real right to elect and, therefore, could not be bound as if he had made an election. At pages 493 and 494 Frankfurter, Circuit Justice, said:

> "The respondent's argument in this case appears to be couched in terms of election, and is based on the theory, which we have rejected, that constructive receipt is a rule the application of which is optional with the Commissioner, and that there was something akin to a real choice available to the petitioner before, or in, 1932. But under our view of constructive receipt, petitioner had no lawful choice other than to report as income such of his salary as was constructively received, either in 1932 or earlier."

Mr. Justice Frankfurter then considered whether or not an estoppel existed. He posed the question in this fashion:

> "Respondent offers another doctrine, which has found some judicial support, that a taxpayer must consistently follow the theory upon which his earlier returns were made."

He pointed out (p. 494) that this alleged doctrine had been repeatedly rejected by the Courts:

> "But this doctrine, characterized by Judge Learned Hand as 'a kind of estoppel as to the law,'

> (*Bennet* v. *Helvering*, 2 Cir., 1943, 137 F. 2d 537, 539, 149 A. L. R. 1146), has been rejected in this Circuit. *Commissioner* v. *Saltonstall*, 1 Cir., 1941, 124 F. 2d 110. And the Second Circuit has rejected it repeatedly. *Bennet* v. *Helvering, supra; Lembcke* v. *Commissioner*, 2 Cir., 1942, 126 F. 2d 940; *Schmidlapp* v. *Commissioner*, 2 Cir., 1938, 96 F. 2d 680, 118 A. L. R. 297; *Bigelow* v. *Bowers*, 2 Cir., 1934, 68 F. 2d 839, certiorari denied, 1934, 292 U. S. 656, 54 S. Ct. 864, 78 L. Ed. 1504."

And finally he concluded that in any event a defense of estoppel, acquiescence or election should have been pleaded by the Commissioner in his answer, together with facts which he claims supported such defense. The pleading in the case at bar contains no separate defenses.

To the same effect the Tax Court in *Wiener Machinery Co., Inc.* v. *Commissioner*, 16 T. C. 48, 52, 53 (1951) said:

> "If his agents erred in failing to find error in the petitioner's treatment of the unused excess profits credit adjustments in the excess profits tax returns for 1944 and 1943, the respondent cannot perpetuate errors of either the taxpayer or his agents in determining the amount of the 1945 excess profits tax liability of the petitioner."

And Holmes, C. J., said in *Commissioner* v. *Rowan Drilling Co.* (C. C. A. 5), 130 F. 2d 62, 65:

> "• • • an unlawful course of procedure (in reporting income), however prolonged, is not made lawful by acquiescence of the Commissioner" (words in parentheses supplied).

Also Swan, C. J., in *Mt. Vernon Trust Co.* v. *Commissioner* (C. C. A. 2), 75 F. 2d 938, certiorari denied 296 U. S. 587, said at page 940:

> "It is urged that the Commissioner's acceptance of the returns for 1928 and prior years is a recognition that the method used in those years was proper, but no estoppel can arise against the Commissioner from his acceptance of the return. In *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 362, 50 S. Ct. 251, 74 L. Ed. 901, a similar argument was rejected, with the suggestion that the failure of the Commissioner to correct the return may as well be attributable to error or oversight or lack of information as to his opinion of the propriety of the item. See, also, *J. C. Nichols Land Co.* v. *Com'r.*, 65 F. (2d) 437, 438 (C. C. A. 8); *Tonningsen* v. *Com'r.*, 61 F. (2d) 199, 200 (C. C. A. 9); *Bonwit Teller & Co.* v. *Com'r.*, 53 F. (2d) 381, 384, 82 A. L. R. 325 (C. C. A. 2)."

The Court below relied upon *Advertisers Exchange, Inc.* v. *Commissioner*, 25 T. C. 1086; affirmed 240 F. 2d 958 (C. A. 2). However, in that case the taxpayer, without the consent of the Commissioner, had changed from a "completed contract basis" of accounting to a "percentage of completion basis" method. A change of this nature is expressly proscribed by Regulation Sec. 39.41-2(c) (2a). Each method was permissible. Each method, when consistently followed, clearly reflected the taxpayer's income. It was properly held, therefore, that the change could not be made without the Commissioner's prior consent. It should be observed that the Court in that case did not perpetuate an error, since no error had been committed in the first place.

Conclusion.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

JOHN S. CHAPMAN,
Counsel for Petitioner.

August 14, 1961.

Appendix No. 1.

Opinions in the Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 13,420

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

THE O. LIQUIDATING CORPORATION

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

Argued February 23, 1961

Before KALODNER, STALEY and FORMAN, *Circuit Judges.*

OPINION OF THE COURT

(Filed June 14, 1961)

By KALODNER, *Circuit Judge.*

Did the Commissioner of Internal Revenue abuse his statutory discretion in refusing to grant his consent to a change in the taxpayer's method of accounting for a material item of gross income?

That is the critical question presented by the Commissioner of Internal Revenue's petition for review of the Tax Court decision which answered it in the affirmative.[1]

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[1] The Memorandum Findings of Fact and Opinion of the Tax Court are reported at 19 CCH Tax Ct. Mem. 154 (1960).

Appendix No. 1.

Treasury Regulations 118, §39.41-2, relating to Sections 41 and 42 of the Internal Revenue Code of 1939[2] provide in relevant part as follows:

> "(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. . . . Permission to change the method of accounting will not be granted unless the taxpayer and Commissioner agree to the terms and conditions under which the change will be effected. . . ."

The relevant facts, as stipulated and found by the Tax Court, are not in dispute and may be summarized as follows:

The O. Liquidating Corporation ("taxpayer"), has at all times kept its books and reported its income on a calendar year and accrual basis. In 1918 taxpayer established, and has since broadened and continuously maintained, a group insurance plan for its employees. The premium on the policies obtained pursuant to that plan were paid by taxpayer in monthly installments. All of the policies here involved were written by one mutual insurance company and all had a policy year coterminous with the calendar year. With one exception, each of the policies contained an identical provision, which is set out in the margin,[3] for the payment of annual dividends.[4] Pursuant

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[2] 26 U.S.C.A. 1952 ed., Sections 41, 42.

[3] "The surplus, if any, to be distributed upon this policy as a dividend shall be ascertained and distributed by the Society annually as of each policy anniversary provided this policy shall have been continued in force by the payment of all premiums hereunder to such policy anniversary; otherwise the Society shall not distribute any surplus upon this policy. Any surplus apportioned to this policy in accordance with this provision shall be paid in cash to the Employer, or, upon written notice to the Society by the Employer, may be applied by the Employer to the payment of any premium hereon."

[4] The record does not disclose the dividend provision contained in one of the policies.

to that provision, the actuarial department of the insurance company would, in January of each year, compute the surplus earned in the prior year and recommend a dividend formula to the board of directors. At its regular meeting in February, the board would consider the actuarial report and determine the amount of dividend, if any, to be distributed.

The policies here involved were purchased on varying dates beginning with 1941. Taxpayer has consistently followed the practice of recording on its books the amount of the monthly insurance premiums as an expense in the calendar year in which paid. During the years 1941 through 1952, inclusive, taxpayer consistently followed the practice of recording as of the year end an amount representing an accrual of the dividends to be paid by the insurance company and to be received by taxpayer in the subsequent year, which amount was recorded in the insurance expense account as an off-set to the gross premiums recorded therein for such year. In its federal income and excess profits tax returns for all years prior to 1953, petitioner claimed as a deduction for group insurance expense the net amount remaining after the reduction of the amount of gross premiums paid within the calendar year by the amount of dividends recorded as an accrual as of the year end.

Thus, for the year 1949, taxpayer recorded in its insurance expense account gross premiums in the amount of $170,641.05 and an accrual in the amount of $37,713.05, representing dividends to be paid by the insurance company and to be received by taxpayer in the year 1950, leaving a net expense of $132,928.00 which was claimed and allowed as a deduction in its federal income tax return for such year. During the calendar year 1950 taxpayer received insurance dividends in the amount of $37,713.05.

During the years 1941 through 1949, taxpayer accrued as of the end of the year, the exact amount of dividends

that were to be received by it in the subsequent year. In 1950, taxpayer underaccrued the amount of the dividend it subsequently received in 1951, and in 1951, taxpayer overaccrued this item. In 1952 taxpayer again estimated the exact amount.

Taxpayer, in order to correct the 1950 underaccrual and the 1951 overaccrual, made adjustments in its 1951 and 1952 tax returns, the years in which the dividend was actually received. The Commissioner, however, upon auditing taxpayer's returns for 1950, 1951 and 1952 made the necessary adjustments in the years in which the dividend was accrued, 1950 and 1951 respectively.

In 1953, taxpayer made a significant departure from its prior consistent method of accounting for the insurance dividends. In that year, taxpayer, without requesting the consent of the Commissioner, accrued no dividends and deducted the full amount of its group insurance premiums from its federal income and excess profit tax return. In 1954, taxpayer received dividends totalling $114,117.44, which amount it reported on its return for that year.[5] The obvious effect of this change was a deduction for group insurance expense for the year 1953 consisting of gross premiums only with no corresponding off-set for insurance dividends.

In 1956, upon examination of taxpayer's federal income and excess profit tax return for the year 1953, the Commissioner made an adjustment decreasing taxpayer's claimed deduction for group insurance expense by $114,117.44, *i.e.*, he determined that the dividend received by taxpayer in 1954 should have been accrued and reported in 1953. As a result of this adjustment, taxpayer's net

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[5] Taxpayer received a dividend of $72,531.79 in 1953. However, that item had been accrued and reported by it in 1952, pursuant to its consistent accounting practice. Had taxpayer adhered to its prior method of accounting for this item, it would have accrued and reported in 1953 the dividend it received in 1954.

deduction for insurance expenses was reduced from $265,327 to $151,209.56. It is this adjustment which is the single item in dispute here.

The Tax Court held that, since the taxpayer had no right to receive the insurance dividends prior to the determination of the board of directors of the insurance company to set aside a certain amount of surplus for distribution, which determination was always made in the year in which the dividend was paid, the taxpayer's method of accruing and reporting this item in the year prior to payment (receipt) was erroneous. The court further held that the change in the treatment of this item by taxpayer in its 1953 federal tax return did not constitute a change in its method of accounting which would require the prior approval of the Commissioner. Accordingly, the Tax Court held that the dividend received by taxpayer in 1954 accrued in that year rather than in 1953 and that the dividend was properly reported in the later year. However, the court accepted the Commissioner's alternative argument that, in view of the above holdings, the taxpayer erred in failing to report in 1953 the dividend it received in 1953 but which it had accrued and reported in 1952. The court adjusted the 1953 return accordingly and determined a deficiency of $50,772.28 for that taxable year.[6] In a dictum, however, the court stated that since the dividend received in 1953 had already been accounted for in 1952, "it appears that petitioner [taxpayer] will have adequate relief from double inclusion of an item of gross income by virtue of those sections [1311 *et seq.*] of the 1954 Code."[7] The net result of the Tax Court's holding, and of its dictum (if applied), is that one year's dividend will be deleted and the net insurance expense deduction for that year increased to that extent.

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[6] The deficiency determined by the Commissioner, using the dividend for 1954 rather than 1953, was $78,851.43.

[7] 19 CCH Tax Ct. Mem. at 159.

Appendix No. 1.

On this appeal, the Commissioner does not contest the Tax Court's determination that the annual dividends accrued in the year of receipt so that the taxpayer's former method of reporting the insurance dividends was incorrect under the accrual method of accounting. He contends, however, that under the applicable statutes and Regulations, a taxpayer may change the method of accounting employed in reporting his income only if he first obtains the consent of the Commissioner; that the reason for this rule is that a change of accounting method will normally involve a distortion of the taxpayer's income for the year of change and, in order to protect the Government against a loss of revenues, the Commissioner conditions his consent to the change on the taxpayer's acceptance of adjustments which would prevent the avoidance of tax liability. The Commissioner further urges that this rule applies not only to a change in an over-all method of accounting but also to a change in the method of accounting for a material item; that the change which the taxpayer made in the instant case constitutes a "change" requiring the prior approval of the Commissioner notwithstanding that taxpayer's prior method of accounting for this item was erroneous, and, therefore, the Commissioner properly, in making the adjustments here in issue, refused to allow taxpayer to unilaterally change its method of accounting for this item.

Taxpayer, on the other hand, contends that, in view of the uncontested determination of the Tax Court that the insurance dividends were properly reportable in the year of receipt under the accrual method of accounting, no other method would "clearly reflect income" and that the Commissioner "may not insist upon adherence to a method which fails to 'clearly reflect income.'" It argues "that correction of an error to conform to a long-standing method of accounting is not a change in accounting method and the Commissioner may not require the taxpayer to perpetuate an error." Taxpayer further asserts

that if equitable considerations are relevant in this determination, it is not possible here to determine where as between the Government and the taxpayer the equities rest in view of the fact that for years taxpayer has been prepaying the tax on this item and that taxpayer paid taxes to which it would not otherwise have been subject at the expiration of the excess profits tax of World War II in 1946 and whenever the tax rates were reduced. Finally, taxpayer urges that we modify the Tax Court's decision, which brought into 1953 the dividend which had already been reported in 1952 (relief from which the Court indicated could be secured by way of a claim for refund under §§1311 *et seq.* of the 1954 Code), by directing the deletion of this item from the 1953 return—execute the dictum of the Tax Court as it were.

Section 42 of the Internal Revenue Code of 1939 provides that "items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." Section 41 of the 1939 Code provides that

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect income."

Pertinent Treasury Regulations, earlier set forth provide that a taxpayer who desires to change the method of accounting employed in reporting his income must first "secure the consent of the Commissioner" to the change,

and that permission to make it will not be granted "unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected."

The taxpayer's argument proceeds as follows:

> "The taxpayer may not employ a method of accounting which does not clearly reflect income. If the taxpayer's method fails clearly to reflect income, then under Section 41 of the Internal Revenue Code of 1939, the Commissioner can insist that a method be employed which does clearly reflect income. . . ."
> "However, the Commissioner has not power to require a taxpayer, for any reason, to employ an accounting method which fails clearly to reflect income. His right to determine what method a taxpayer shall employ has limitations. One important limitation—the limitation which here controls—is that no authority is vested in the Commissioner to disregard the actual transaction and to readjust the income on a basis which would not clearly reflect income."

This argument is premised on Caldwell *v.* Commissioner, 202 F. 2d 112 (2 Cir. 1953); Commissioner *v.* Frame, 195 F. 2d 166 (3 Cir. 1952); Commissioner *v.* Mnookin's Estate, 184 F. 2d 89 (8 Cir. 1950), and subsequent similar cases. Those cases involved involuntary changes in the method of accounting of taxpayer required by the Commissioner because the old method of accounting did not clearly reflect income and in them the Commissioner attempted to make the necessary adjustments so that items would be neither omitted or duplicated. The courts held that the taxpayer could not be required to make such adjustments. As stated in Advance Truck Co. *v.* Commissioner, 262 F. 2d 388, 391-92 (9 Cir. 1958):

> "We believe that it is a fair statement to say that the rationale of such cases is that the Commissioner

> is not empowered in the year of change-over to assess a deficiency in tax for the year of the change-over premised on items of income which the taxpayer should have, but failed to include, in his income tax return for the tax year or years prior to the change, based upon the method employed by the taxpayer in keeping his books of account for such prior year or years."

The rule stated is not applicable here for the simple reason that the Commissioner did not attempt to change taxpayer's method of accounting and impose adjustments, but, on the contrary, he sought only to prevent a change in the taxpayer's method of accounting for this item to which he had not first given his consent and to require adherence to the method used for many years prior to 1953. This distinction was recognized in Goodrich *v.* Commissioner, 243 F. 2d 686 (8 Cir. 1957), where it was said (pp. 688-89):

> "It [the Regulation] allows him [the Commissioner] to impose adjustments in relation to a taxpayer's income status of other years, only as a term or condition on which he will consent to a change in the taxpayer's method of accounting for purposes of the latter's current tax return. But it does not allow him to impose such adjustments in relation to the taxpayer's income status of other years, except as a matter of agreement or acceptance on the taxpayer's part.
>
> "If the taxpayer refuses to agree to the terms or conditions so imposed and to accept the adjustments required by the Commissioner to be made, the result is in general to leave the situation simply as one in which the taxpayer is without legal right to make use of a change in his accounting method for purposes of his current taxability and return. . . .
> "*It is not open to either the Commissioner or the taxpayer unilaterally to make a shift,* whether of

> income or of outgo, to another year than that for which its tax status, 'in accordance with the method of accounting regularly employed in keeping the books of such taxpayer,' has properly been created. Security Flour Mills Co. *v.* Commissioner, 321 U. S. 281, 286-87, 64 S. Ct. 596, 599, 88 L. Ed. 295." (emphasis supplied)

The rationale of the Regulation here involved is that virtually any material change in the method of reporting income or deduction items will result in a distortion of taxable income, and it is the Commissioner's responsibility to insure that the distortion will not be to the detriment of the Government. The Commissioner accomplishes this by withholding his consent until the taxpayer agrees to adjustments that will prevent, *inter ali*, duplications of deduction items or omission of income items as a result of the change. Brookshire *v.* Commissioner, 273 F. 2d 638 (4 Cir. 1960), cert. denied 363 U. S. 827.

On review of the record we agree with the Commissioner's contention that while taxpayer did not change its over-all method of accounting it did change its treatment of a significant item—the insurance dividends which amounted to $114,000—and that its action constituted a change in the method of accounting within the meaning of the Treasury Regulations. The Tax Court, in our opinion, erred in finding to the contrary.

In Rev. Rul. 59-285, 1959-2 Cum. Bull. 458, the Internal Revenue Service, in confirming its interpretation and practice with respect to Section 41 of the Internal Revenue Code of 1939 stated in part (1959-2 Cum. Bull. pp. 459-60):

> "Under the 1939 Code, the prior consent of the Commissioner is required in order for a taxpayer to change his method of accounting *with respect to a material item. Prior consent* must be secured from the Commissioner whether or not the taxpayer

regards the method from which he desires to change to be proper. . . .

"Accordingly, under the 1939 Code as well as under the 1954 Code, taxpayers, employing the accrual method of accounting, who have consistently deducted *a material item* in the year paid rather than the year accrued, must obtain *the prior consent* of the Commissioner before changing such method of accounting whether or not the taxpayer regards the method from which he desires to change to be proper." (emphasis supplied)

It is well-settled that administrative interpretation of the Internal Revenue Service is entitled to great weight and should be followed unless clearly inconsistent with the statute. Corn Products Co. *v.* Commissioner, 350 U. S. 46, 52-53 (1955). The interpretation stated is certainly not inconsistent with the statute.

It is not dispositive that taxpayer's former consistent method of reporting the insurance dividends in the instant case was not correct under the accrual accounting system since it could not be changed without the Commissioner's prior consent.

As was said in Advertisers Exchange, Inc., 25 T. C. 1086, 1092-93 (1956), aff'd 240 F. 2d 958 (2 Cir. 1957),

> "Consistency is the key and is required regardless of the method or system of accounting used. . . . And a change from one method of accounting to another is seldom possible without some distortion of income. Thus, respondent [Commissioner] may, as here, reject any change in the accounting treatment *of items of income* made without his prior consent and approval of compensating adjustments to insure that distortions arising therefrom are not at the expense of the governmental revenue. Kahuku Plantation Co. *v.* Commissioner, 132 F. 2nd 671.

> "As heretofore noted, the effect of respondent's determination is to require the continued use of the accounting method consistently employed by petitioner for a number of years. *To do so is within the broad administrative discretion accorded respondent under the statute and is not to be disturbed unless an abuse of discretion is evident. . . .*" (emphasis supplied.)

To the same effect see 2 Mertens, Federal Income Taxation, §§12.08-.09 (rev. ed. 1955).

The "broad discretion" of the Commissioner in determining whether to consent to a change was settled in Brown *v.* Helvering, 291 U. S. 193 (1934). See also Commissioner *v.* Hansen, 360 U. S. 446, 467 (1959).

It may be noted that the Tax Court, in its opinion, did not advert to the "broad discretion" of the Commissioner and did in fact not hold that he had abused his statutory discretion in refusing to give retroactive consent to taxpayer's change in its method of accounting for the insurance dividends here involved.

On consideration of the record we certainly cannot say that the Commissioner abused his statutory discretion in refusing to grant retroactive consent in the instant case to taxpayer's unilateral change in its method of accounting of the very sizable dividend income involved.

For the reasons stated the Decision of the Tax Court will be reversed and the cause remanded with directions to proceed in accordance with this opinion.

FORMAN, *Circuit Judge,* dissenting.

I cannot agree with the majority that there was any change in the accounting method of a material item of the taxpayer's income. I find with the Tax Court that the treatment by the taxpayer of its dividend income in years previous to 1953 "was an erroneous treatment and incon-

sistent with the method of accounting regularly employed by [taxpayer] in keeping its books." It did not reflect in its 1953 return anticipated 1954 dividends to which it had no claim of right in 1953. In doing so it was correctly applying the accrual method of accounting which it had adopted and the change it effected did not require the consent of the Commissioner. Cf. Beacon Publishing Co. *v.* Commissioner of Internal Revenue, 218 F. 2d 697 (10 Cir. 1955).

I would affirm the decision of the Tax Court.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

Appendix No. 2.

Statutes and Regulations Involved.

GENERAL RULE.

1939 Code SEC. 41. The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

1939 Code §42. *Period in which items of gross income included*

(a) General rule. The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

Reg. 118, §39.41-1. *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as

gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it. [Reg. 118, §39.41-1.]

Reg 118, §39.41-2. *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§39.42-2 and 39-42-3.) On the other hand, appreciation in value of prop-

erty is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see §39.22 (c)-5.)

(b) The true income, computed under the Internal Revenue Code and, if the taxpayer keep books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§39.22 (c)-1 to 39.22 (c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see §39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§39.22 (a)-7 and 39.23 (a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made

shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22 (d) and §§39.22 (d)-1 to 39.22 (d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in §§39.44-1 and 39.44-3, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year. [Reg. 118, §39.41-2.]

Reg. 118 §39.41-3. *Methods of accounting.* It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and §39.54-1.) Among the essentials are the following:

Appendix No. 2.

(a) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22 (c) and §§39.22 (c)-1 to 39.22 (c)-8, inclusive);

(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. [Reg. 118, §39.41-3.]

Reg. 118, §39.41-4. *Accounting period.* The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding, unless, with the approval of the Commissioner, he has changed his accounting period. See §39.46-1. [Reg. 118, §39.41-4.]